

## MY ASSET ALLOCATION

### PROTECTING AGAINST SHORT-TERM RISK



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It still surprises me the extent to which private client investment firms ignore managing clients' asset allocations on a dynamic or tactical basis and believe that fund or stock picking is the way to drive performance. To our mind, asset allocation is the biggest driver behind investment performance and is a key component of Quartet Capital's investment offering. This is where we seek to add value for our clients.

Currently we are living in a very unstable macro environment. The biggest influences on returns are the extent to which geopolitical factors will influence market sentiment; whether we are entering an inflationary or deflationary environment; and does the recent pullback in global equity markets spell the end of the recovery started several months ago?

Our view is that we are just going to have to get used to political intervention – be it with Germany limiting short-selling or Europe muddling through the EU banking stress tests. This intervention will inevitably lead to higher levels of volatility as skittish investors focus on the latest news.

In terms of the global economic recovery, we view the data coming through in the UK, Europe and US as worrying and have increased our fears that we may suffer a double-dip recession. We remain concerned that markets are still in a long-term cyclical bear market and view the drop in risk asset prices as a healthy correction to markets that had spiked. Until global price/earnings ratios are in single digits, we fear more downward lurches.

If the economic recovery does gain traction, this market setback may create short-term buying opportunities, primarily in equities although corporate debt also begins to look interesting. Corporate bond spreads have widened but more as a result of government debt prices rallying strongly. Despite the rally in conventional government debt, we have maintained a large exposure.

This has been done for two main reasons. First, we remain fearful of deflation and are in agreement with the Monetary Policy Committee that UK inflation will quickly reverse in the second half of the year. Second, with big macro risks around, government debt has benefited from a flight to safety. To further protect portfolios, we hold a position in physical gold as a form of disaster insurance.

Elsewhere we have little Bric, Asia or emerging market exposure due to our concerns that these markets are overvalued and offer little upside on a risk-adjusted basis. We also have no exposure to Europe – either currency, debt or equities across our sterling or US dollar accounts. But we are getting more positive about the prospects for Germany due to its large export sector and we might allocate funds there while hedging out currency exposure. In other currencies we maintain a significant exposure to the US dollar and despite the recent rise in sterling, view the dollar as being the lesser of two evils.

In relation to other assets classes, our hedge fund and absolute return positions have held up well and we remain positive on the outlook for volatility-based investment strategies. We hold two 'special situation' positions in the UK commercial property sector. We fear that limited upside now exists in the sector but special situations by their nature should not require broad market catalysts to come to fruition. We also hold a position in a 'busted' structured product that should produce a gross redemption yield of around 15% over the next 18 months.

Recent launches look uninspiring due to current interest rate levels but decent opportunities exist in the listed secondary market if one can accurately price the underlying constituents of the structure and can get comfortable with counterparty risk.

To conclude, we are pretty worried about short-term risks and have positioned portfolios accordingly. We hope to be surprised on the upside.

#### MORE ON . . . Colin McInnes

Colin McInnes founded Quartet Capital Partners LLP in 2009 and is the managing partner. He has more than 14 years' experience in private client investment management, having previously been a board director at Berry Asset Management and formerly worked at Close Brothers and Heritage Capital. He studied economics at Bristol University and is a fellow of the Chartered Institute of Securities and Investments.

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